

**IAWC EXHIBIT 1.0R**

**ILLINOIS-AMERICAN WATER COMPANY**

**REVISED DIRECT TESTIMONY**

**OF**

**RONALD D. STAFFORD**

**Docket No. 01-0556**

**REVISED DIRECT TESTIMONY**

**OF**

**RONALD D. STAFFORD**

**WITNESS IDENTIFICATION**

**Q. Please state your name and business address.**

A. My name is Ronald D. Stafford, and my business address is Illinois-American Water Company ("Illinois-American" or "IAWC"), 300 North Waterworks Drive, P.O. Box 24040, Belleville, IL 62223-9040.

**Q. What positions do you hold with Illinois-American?**

A. I am Director of Rates and Revenue and serve as Assistant Treasurer.

**Q. What is your educational background?**

A. I am a graduate of Ball State University with a Bachelor of Science Degree in Accounting, and have a Masters in Business Administration with concentrations in Management and Finance from Southern Illinois University at Edwardsville. I am licensed in Illinois as a Certified Public Accountant. I have co-authored a paper on Meter Reading Management and spoken on this topic at a joint national conference of the American Water Works Association ("AWWA") and the Water Environment Federation, in addition to the Illinois Section of the AWWA. I have also attended various seminars, including the Seminar on Water Utility Regulation sponsored by the National Association of Regulatory Utility Commissioners and participated in continuing education programs

sponsored by American Water Works Service Company, Inc. (the "Service Company"), an affiliate of Illinois-American.

**Q. Please discuss your business experience and present duties.**

A. I began my employment with the Service Company in Richmond, Indiana as an Accountant in September 1981. In May 1983, I was promoted to the position of Rate Analyst. In June 1986, I was promoted to the position of Senior Rate Analyst. In May 1990, I was promoted to the position of Revenue Requirement Specialist and remained in that position with the Service Company until my promotion to Assistant Director of Rates and Revenue for Illinois-American in October 1993. I was named an Assistant Treasurer of Illinois-American in December 1993. In January 1996, I was promoted to the position of Director of Rates and Revenue. Effective February 2000, I also serve as Director of Rates and Revenue and Assistant Treasurer on behalf of Iowa-American Water Company, an affiliate of Illinois-American.

My responsibilities primarily involve the preparation and presentation of applications for rate adjustments and other correspondence with the Illinois Commerce Commission (the "Commission") and the Iowa Utilities Board. I also am responsible for preparation of annual business plans and other financial analysis. I have previously presented testimony on accounting, financial, and rate matters before this Commission, the Iowa Utilities Board, the Missouri Public Service Commission and the Public Utilities Commission of Ohio.

**PURPOSE OF TESTIMONY**

**Q. Are you familiar with the Petition for Approval of a Savings Sharing Methodology filed in this proceeding?**

A. Yes. The petition was filed in response to Finding 9 at page 50 of the Order issued in Docket 00-0476, which required IAWC to file a petition seeking approval of a specific methodology for quantification of savings.

**Q. What is the purpose of your Revised Direct Testimony in this proceeding?**

A. The purpose of my Revised Direct Testimony is to discuss IAWC's proposed methodology for quantifying savings resulting from the acquisition of assets previously used by Citizens Utilities Company of Illinois ("CUCI") in the provision of water and wastewater service to customers in the state of Illinois. The Commission approved the transaction to acquire such assets ("Acquisition") in Docket 00-0476.

**Q. Did you previously file Direct Testimony discussing a methodology for savings sharing?**

A. Yes. This Revised Direct Testimony was prepared after discussion with the Commission's Staff of the methodology proposed in the prior testimony. At the hearing held in this proceeding, IAWC intends to sponsor only this Revised Direct Testimony and accompanying Exhibits (and not the prior testimony and exhibits).

**METHODOLOGY FOR QUANTIFYING SAVINGS**

**Q. Will savings result from the Acquisition?**

A. Yes. The Acquisition will produce significant economies and efficiencies which will result in a reduced level of costs as compared to the level which would exist for the separate companies on an aggregate basis ("Acquisition Savings" or "Savings").

**Q. What methodology does Illinois-American propose for quantification of the Acquisition Savings?**

A. Illinois-American proposes a two-part methodology: one part covering Savings unrelated to the cost of capital; and the other covering cost-of-capital related Savings.

**Q. Please explain the methodology for quantification of Savings not related to the cost of capital.**

A. To quantify Acquisition Savings not related to cost of capital, the methodology is as follows: (1) IAWC will first determine the level of pre-Acquisition costs for each Savings category for the calendar year immediately preceding announcement of the

## Exhibit 1.0R

Acquisition, that year being 1998; (2) IAWC will then substantiate that elimination of specific 1998 costs ("Base Year Costs") has resulted from the Acquisition; (3) IAWC will adjust the Base Year Costs to the level for the rate case test year using known changes in cost levels for historical periods and forecasted cost data developed for the projected test year rate filing (where assumptions are used to determine Savings for a particular Savings category, such assumptions will be identified and explained); and (4) in rate proceedings filed on or prior to May 15, 2004, fifty percent of the Savings so demonstrated will be allocated to IAWC's shareholders and fifty percent will be allocated to ratepayers, in accordance with the Commission's Order in Docket No. 00-0476. The shareholders' portion of Savings would be added to the revenue requirement determined in the rate proceedings. For all Savings categories, cost increases will be netted against cost decreases.

For the Base Year Costs, CUCI data will be utilized. IAWC will make available to Staff and Intervenor all CUCI data available to IAWC including, but not limited to, CUCI general ledgers and/or other documentation and records that are reasonably required to document the Base Year Costs.

To adjust the Base Year Costs to the level for the test year in a rate proceeding, IAWC will utilize actual CUCI data for years already concluded, or, if CUCI data is unavailable or distorted, normalized IAWC data for a comparable cost category/item. If no comparable IAWC cost category/item exists for a given year, the Gross Domestic Product ("GDP") index will be used to update the Savings amount for that year. As with the quantification of Base Year Costs, all available CUCI or IAWC data reasonably needed to document the updated Savings calculation will be provided. To update the Savings calculation for years not yet complete, IAWC will utilize projected IAWC data for a comparable Savings category/item that is developed as a part of the forecast submitted in the proceeding.

As indicated above, IAWC will not utilize distorted CUCI or IAWC data for years which have already occurred, during the adjustment process. In determining whether data is distorted, IAWC will consider operating information relating to the expense and

compare the expense levels for the year to prior year(s). Any unusual trends or unusual operating conditions will be analyzed and documented for review.

IAWC's management who will be responsible for the decisions regarding whether or not data is distorted will include the Company's Vice President and Treasurer.

For each Savings category, IAWC will explain the causal connection between the Acquisition and the resulting Savings.

**Q. Please discuss the second part of the methodology related to cost-of-capital Savings.**

A. The cost of capital methodology itself has two approaches; one for the area presently served by CUCI, and the other for IAWC's other service areas. Each approach will be discussed below.

Citizens Service Territory:

In connection with the Acquisition, IAWC will assume approximately \$23,325,000 of debt currently on the books of CUCI's parent, Citizens Communications Company ("CCC"). IAWC expects that the Acquisition will result in certain cost of capital-related savings equal to the difference between the assumed debt ("Assumed Debt") interest rate when CCC was responsible for the Assumed Debt and the Assumed Debt interest rate when IAWC or its affiliates was responsible for the Assumed Debt ("Cost of Debt Savings"). The Assumed Debt interest rate would be linked to the Bond Market Association Municipal Swap Index ("Benchmark"), so that the Commission can estimate what the Assumed Debt interest rate would have been absent the Acquisition. The procedure for calculating the savings on the Assumed Debt is as follows:

$$ADS_t = \text{Spread} + \text{Bench}_t - ADI_{IAWC,t}$$

$$\text{Spread} = ADI_{CCC,0} - \text{Bench}_0$$

Where:	$ADS_t$	=	Savings on the Assumed Debt at time $t$ ;
	Spread	=	Difference between interest rate on Benchmark and Assumed Debt for the twelve months immediately

**Exhibit 1.0R**

			Assumed Debt for the twelve months immediately preceding the acquisition;
	$Bench_t$	=	Interest rate on the Benchmark at time $t$ ;
	$Bench_0$	=	Average interest rate on the Benchmark for the twelve months immediately preceding the acquisition;
	$ADI_{IAWC,t}$	=	Interest Rate on Assumed Debt to IAWC at time $t$ ; and
	$ADI_{CCC,0}$	=	Average interest Rate on Assumed Debt to CCC for the twelve months immediately preceding the acquisition.

To calculate the total Cost of Debt Savings in dollars, the Commission would apply the Cost of Debt Savings to the portion of Assumed Debt reflected in the capital structure allowed for each IAWC rate case through May 2004. Fifty percent (50%) of the total Cost of Debt Savings in dollars would be included in the revenue requirement for only the IAWC service territory acquired in Docket No. 00-0476 (“Citizens service territory”). However, if the Assumed Debt interest rate increases following the Acquisition, vis-à-vis the Assumed Debt interest rate absent the Acquisition (as estimated by the sum of the Benchmark and spread), then the increase in the Assumed Debt interest rate would be absorbed by IAWC.

Non-Citizens Service Territory:

In addition to the Assumed Debt, for the Acquisition to occur, IAWC will issue additional short-term debt that, together with the Assumed Debt, will not exceed \$137,500,000. The debt financing will be done through American Water Capital Corp. (“AWCC”). Within twelve months following the Acquisition, IAWC intends to arrange through AWCC for the refunding of this initial short-term debt with permanent long-term financing.

The Assumed Debt would be included in the IAWC capital structure allowed for each rate case through maturity. Thus, the same capital structure would be used for both Citizens and Non-Citizens service territories.

To measure Acquisition-related cost of capital savings for Non-Citizens service territories, the Commission would compare the embedded cost of debt excluding the Assumed Debt (“Cost of Debt excluding Assumed Debt”) to the embedded cost of debt including the Assumed Debt (“Cost of Debt including Assumed Debt”). The additional debt issued as part of the Acquisition financing would be included in both embedded cost of debt calculations.

To calculate the Non-Citizens service territory Acquisition-related cost of capital savings in dollars, the Commission would apply the savings resulting from the difference between the Cost of Debt including Assumed Debt and the Cost of Debt excluding Assumed Debt to the long-term debt ratio in each IAWC rate case through May 2004. Fifty percent (50%) of the Non-Citizens service territory Acquisition-related cost of capital savings in dollars would be included in the revenue requirement for the Non-Citizens service territory. However, if the Cost of Debt including Assumed Debt exceeds the Cost of Debt excluding Assumed Debt, then the increase in the embedded cost of debt would be absorbed by IAWC.

**Q. With regard to the first part of the methodology, have the categories of Savings that will be measured been determined with certainty?**

A. No. It is likely that, in rate cases filed during the period covered by the Savings plan, categories such as the following will be included: labor salary/wage cost, group insurance expense, pension expense and management fees. No final determination of the list of categories of Acquisition Savings, however, has been made, as experience following closing of the Acquisition will be considered in making that determination and the Acquisition is not yet closed. At the time of a rate filing submitted during the period of the Savings plan, Illinois-American will present evidence applying the methodology approved in this proceeding to quantify Savings in each cost category for which IAWC concludes that Savings can reasonably be measured.



191 **Q. Please describe IAWC Exhibit 1.1R.**

192 A. IAWC Exhibit 1.1R provides an example that illustrates application of the first part of the  
193 methodology for measurement of Savings to a cost category, Operation & Maintenance  
194 Labor expense.

196 **Q. Are you aware of a recently announced reorganization that will affect IAWC?**

197 A. Yes. It has been announced that the Board of Directors of IAWC's parent company has  
198 entered into a merger agreement with the German company RWE A.G. ("RWE"),  
199 whereby IAWC's parent will be merged with and into a subsidiary of RWE.

201 **Q. If this parent-level merger is completed, after receiving all shareholder and**  
202 **regulatory approvals, how will the impacts of the merger be considered in the**  
203 **calculation of Savings?**

204 A. The purpose of the methodology proposed in this proceeding is to measure Savings that  
205 result from the Acquisition by IAWC of assets of CUCI, and not from other causes. If  
206 the RWE transaction were to affect the cost levels of IAWC, an adjustment would be  
207 required to eliminate this effect. As a result, the Savings levels determined in future rate  
208 proceedings in accordance with the Order entered in this proceeding will reflect only the  
209 result of the Acquisition. The ratemaking allocation of Savings, if any, which result from  
210 the RWE transaction would be determined in a future case.

212 **Q. Does this conclude your testimony?**

213 A. Yes, it does.